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12 April 2022

Ms Kate Symons  
Chairperson  
Essential Services Commission  
Level 8, 570 Bourke Street  
Melbourne VIC 3000

Submitted electronically: [VDO@esc.vic.gov.au](mailto:VDO@esc.vic.gov.au)

Dear Ms Symons,

**Re: Draft determination for Victorian Default Offer for 2022/23**

Red Energy and Lumo Energy (Red and Lumo) welcome the opportunity to comment on the Essential Services Commission's (the Commission's) draft determination for the Victorian Default Offer (VDO) to apply from 1 July 2022.

The Commission has continued to use a consistent, transparent and predictable approach to price regulation that appears to avoid political considerations. We support this approach as it reassures retailers and potential new entrants that they can recover reasonable costs into the future—supporting effective retail competition. The Commission's draft determination for this VDO is largely in line with its established methodology for previous determinations, albeit with some minor adjustments based on a clear evidence base that includes more accurate information and data about specific cost items.

This approach to some extent mitigates the major risks of price regulation, namely, the potential for retail failure (and its subsequent disruption for consumers) and higher average prices. However, we continue to hold the view that retail price regulation remains a second best policy measure that cannot insulate consumers from rising input costs and can also undermine competition and innovation, to the detriment of consumers. We are now observing significant increases in wholesale costs and the extent and duration of this is unknown; this has not occurred since the VDO was established and therefore, represents a test of the Commission's approach.

The Commission's final determination will capture some of these recent price impacts but as a more general point, higher wholesale prices compound the risks of price regulation and can reveal errors or miscalculations in the calculation of the wholesale component. We strongly encourage the Commission and its consultant, Frontier Economics, to consider how its methodology—the precise details of which are not fully transparent to stakeholders due to its proprietary nature—accounts for these higher wholesale costs and how they impact retailers of different sizes and with different strategies for managing wholesale risk. As the Commission

explains in Appendix A of its draft determination, retail competition is one of the key factors that it must consider as part of its legislative framework.

The UK experience of higher wholesale costs and subsequent retail failure illustrates what can occur when price regulation is poorly administered. In 2021 alone, Ofgem managed 28 Supplier of Last resort events, which disrupted the supply of almost 4 million UK electricity consumers. This has a direct and immediate impact but also undermines competition and deprives consumers from the benefits that competition delivers in the form of more efficient prices and more customer focused services.

### **Wholesale and network costs**

While Red and Lumo support consistency in the determination of the VDO across different regulatory periods, we also support the Commission's decision to adopt Frontier's recommendation to reduce the dataset for consumer load from 5 to 3 years. This decision reflects detailed analysis of the changing nature of the market and Frontier's explanation is clear and reasonable in this instance. However, we note the Commission's statement that it will continue to monitor trends in demand and may use a 'different number of years' in future price reviews.<sup>1</sup>

We caution against frequent changes to the methodology and recommend the Commission provide stakeholders with a notice period of at least 12 months and provide an opportunity for them to review and comment if it is considering similar changes in the future. The decision for this determination is appropriate but there is a clear trade-off between accounting for emerging trends and undermining confidence in future VDO determinations.

Red and Lumo also support the Commission's proposal to adjust its calculation of metering costs. The revised approach will better align with the actual costs that retailers face, noting this is a material and unavoidable cost and that distribution networks' metering and tariff assignment policies are outside retailers' control. Once again, this is an example of the Commission adjusting its approach when it is presented with supporting information and data. It should also consider including a true-up in the 2022-23 VDO in recognition of the previous metering costs that retailers would have absorbed in the previous determination.

### **Retail operating costs and CARC**

Red and Lumo note AEMO's presentation to its Finance Consultation Committee on its draft budget and fees for 2022-23 (available [here](#)). This includes a proposal for a real revenue increase of \$119.6m in FY23 to \$377.1m, which is the result of expenditure increases and a \$40m recovery of the NEM Core accumulated deficit. AEMO advises that this is necessary to account for, among other things, a '*real increase in expenditure arising from labour increases in*

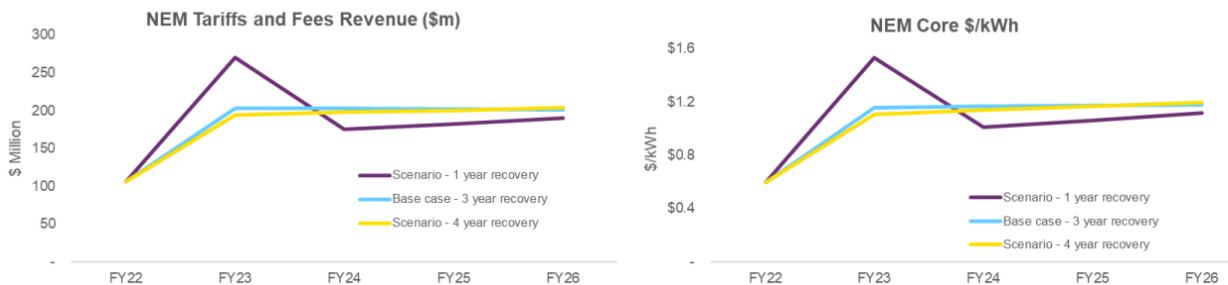
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<sup>1</sup> Essential Services Commission (2022), *Victorian Default Offer 2022–23: Draft decision*, page 10

operational areas, uplifting some critical central functions, incremental labour associated with new systems’, and ‘increased Cloud, IT support costs, predominantly for 5MS/GS’.

We also note the trajectory of AEMO’s revenue for the coming years, depicted in the following chart from its presentation. There are also numerous references to forthcoming regulatory initiatives, including the Energy Security Board’s Post 2025 NEM Market Design work program.

## NEM Core Fee pathways and impacts



We have numerous reasons for including this information in our VDO submission. Firstly, this is a material and unavoidable cost for retailers in 2022-23 and needs to be captured in the VDO. We trust the Commission will be able to account for AEMO’s final fee proposal in the final VDO determination.

Secondly, the discussion of AEMO’s financial position and its need to remedy its debt position illustrates the volume of regulatory initiatives that retailers have had to implement in recent years, as well as the expected volume of forthcoming measures. This not only generates significant costs for retailers that need to be recovered through regulated prices but these initiatives crowd out other investments in billing systems, technologies, customer initiatives and other measures to improve operational efficiency. The Commission is also aware that retailers operating in Victoria have had to implement additional measures in recent years following the Thwaites Review and the Commission’s subsequent program of work. This includes the significant costs required to include a best offer calculation on bills.

The Consumer Data Right (CDR) is another initiative that retailers will need to account for in 2022-23. While the Commission has chosen not to include an additional allowance, the finalisation of the CDR Rules for the energy sector and the ongoing process to finalise technical standards will allow retailers to provide more rigorous cost estimates ahead of the final VDO determination.

In light of the extensive regulatory program, we welcome the Commission’s decision to resist calls from consumer representatives to adjust the retail cost component of the next VDO for assumed productivity gains. We also note this is a significant reason why retailers have not

been able to innovate in the manner that the Commission assumes might have occurred in a competitive market, which is the focus of considerable discussion in the Commission's most recent Victorian Energy Market Report.

As discussed, we support the Commission's use of an established methodology (including a benchmark for retail operating costs) for the estimation of individual cost components, with adjustments based on information and data from stakeholders and additional analysis. It then cross checks against data it obtains directly from retailers. In the past, this has led to the inclusion of additional allowances for bad debt attributable to the pandemic, the cost of the Payment Difficulty Framework, additional regulatory requirements in Victoria, and the cost to implement 5 minute settlement.

The Commission should retain this approach for the final determination. This means it should account for the cost of the CDR if retailers provide adequate cost data but also resist amending the allowance for acquisition and retention costs, which it has chosen not to reduce in its draft determination. This is relevant for the implementation of the Energy Fairness Plan (EFP), which prohibits some acquisition and retention activities and which some stakeholders have suggested will reduce the cost of these activities and as a consequence, justify a reduction of the CARC allowance.

There is no basis for assuming these costs will fall under the EFP so we welcome the Commission's decision not to change the allowance in this VDO. The precise impact of the EFP is not yet apparent and there is no data available at this point to suggest that acquisition, retention or operating costs will increase or decrease. It is likely that retailers will need to adopt other acquisition strategies that are less targeted (and potentially less effective) so cost per customer may increase. Similarly, the significant changes to penalties for non compliance and uncertainty about how the Commission will administer the new framework may add to compliance and operating costs overall. The Commission must continue to use a data driven approach, rather than relying on assertion or a preconceived idea about the EFP's impact.

While not directly relevant for this determination, this discussion of retail costs raises the issue of the sustainability of the current benchmark and cross checking method beyond this determination. It is not clear that it adequately accounts for all reasonable costs, including the cost of implementing the vast range of regulatory initiatives in recent and coming years, as it reflects operating costs from a small jurisdiction in 2017.

We look forward to further engagement with the Commission on this point. Should it change its methodology, this should only occur following an open and consultative process with stakeholders that provides sufficient notice of any change. The Commission would need to develop a more comprehensive and fit for purpose data request than it currently uses to cross check the benchmark, while also acknowledging the limits of backward looking approaches. It would need to be mindful of the potential impact on smaller retailers from errors of methodology, noting they tend to have higher average costs due to the largely fixed and lumpy nature of some elements of retail operating costs such as billing systems. Smaller retailers tend to have less

flexibility to allocate overheads, shared services and other costs such as Unaccounted For Energy across broad customer bases and different customer segments so the potential to undermine competition through methodological errors or from miscalculation is significant.

### **About Red and Lumo**

We are 100% Australian owned subsidiaries of Snowy Hydro Limited. Collectively, we retail gas and electricity in Victoria, New South Wales, Queensland, South Australia and in the ACT to over 1.1 million customers.

We thank the Commission for the opportunity to comment on its draft determination. Please contact Geoff Hargreaves, Regulatory Manager on 0438 671 750 if you have any further queries or want to discuss this submission in more detail

Yours sincerely

A handwritten signature in blue ink, appearing to read "Stefanie Monaco", written over a light blue rectangular background.

**Stefanie Monaco**  
Manager Regulatory Affairs  
**Red Energy Pty Ltd**  
**Lumo Energy (Australia) Pty Ltd**